

Date: January 31, 2011 To: Kathleen Palm Devine, Treasurer From: Craig S. Trujillo, Deputy Chief Auditor Tele: 860.757.9952 <i>CST</i>		City of Hartford Treasurer's Office Investment Management Operations Audit Report 1112
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I. Executive Summary

In accordance with our audit plan for the fiscal year ending June 30, 2011, we completed an audit in January 2011 of the Investment Management Operations of the City of Hartford Treasurer's Office. The purpose of the audit was to evaluate and test internal accounting and operating controls, the accuracy and propriety of transactions processed, the degree of compliance with established operating policy and procedures, and to recommend improvements where required. The results of our examination were reviewed with A. Cloud, Assistant Treasurer; G. Carter, Director of Investments; and, other responsible members of operating management. The summary that follows includes only exceptions disclosed and recommended operating improvements. Management has also noted actions taken or planned including timeframes to resolve each finding and/or recommendation in this report. We thank Treasurer's Office management and staff for their cooperation and courtesies extended to us during our audit.

Background

Pursuant to the Charter of the City of Hartford, the Treasurer and the City of Hartford Pension Commission (the Commission) are named fiduciaries of the Municipal Employees' Retirement Fund (MERF). The Pension Commission, acting on the recommendations of the City Treasurer in her capacity as Secretary of the Pension Commission, is responsible for the approval of the investment of all pension funds and retaining and terminating external investment advisors. As an elected official of the City of Hartford (City), the Treasurer has the sole responsibility for the care and custody of all MERF assets except to the extent that such responsibility is delegated by him/her to an appropriate entity with the approval of the Pension Commission and consistent with his/her other legal obligations. The Treasurer also has the sole responsibility to invest assets of the MERF as well as to recommend the selection of and contract with all investment advisors, subject to the approval of the Pension Commission. With this oversight the Investment Management Unit (IMU), consisting of three employees, is responsible for the day-to-day administration of pension investments. The Finance Department is responsible for the accounting of pension fund investment activity. As of November 30, 2010, the MERF had book and fair market values of approximately \$786 million and \$924 million respectively. Investment returns of 8.7% compared favorably to the target investment return of 8.0%.

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Scope

The scope of our audit included various tests of transactions recorded from July 1, 2009 thru December 31, 2010. The following audit procedures were performed:

- Reviews and evaluations of policies, procedures and related internal operating and accounting controls,
- Tests of monthly general ledger entries and related accounting, recording and balancing processes,
- Reviews of actuarial reports, and
- Tests of management fees and reviews of related contracts.

General

In general, we found the MERF, its investment returns and related operations of the Investment Management Unit (IMU) of the City Treasurer's Office (TO) to be satisfactory. As previously noted, the MERF's investment performance compared favorably with the performance of its designated benchmarks and those of other selected public funds. We also found that IMU actions and activities were well documented in the monthly Pension Commission minutes, agenda items and reports. Although policies and procedures are maintained and are followed for most operational areas, we did note that certain procedures were not documented, as described below in our Audit Results summary. In addition, we noted that policies and procedures regarding or relating to accounting for and recording MERF assets and liabilities and pension investment activity in the Munis Financial Management System (MUNIS) and the City's Comprehensive Annual Financial Report (CAFR) were not documented by the Finance Department. Finally, we noted some unexplained minor variances between the market values used in calculating management fees by the Investment Managers and Bank of New York Mellon (BNYM), the MERF's master custodian bank.

II. Detail Findings

Pension Fund Transfers

Pension fund transfers are required for a number of reasons including allocating balances from City accounts to Investment Manager accounts and transferring total or partial fund balances and interest and dividend income from investment portfolios back to the City. Generally transfers are made by electronically wiring funds from one source to another. Tests of six fund transfers totaling more than \$44.2 million made from July 1, 2010 to December 31, 2010 and reviews of related operations disclosed the following:

1. Investment Management Agreements contain a Specimen Signature form that lists individuals from the TO and IMU who are authorized to provide verbal and written investment related instructions on behalf of the MERF. While these forms are currently up to date, we noted there were no procedures detailing when and under what circumstances Specimen Signature forms are to be updated and sent to external Investment Managers and the fund custodian. Management informed us that external Investment Managers and the fund custodian are immediately e-mailed and also mailed copies of new specimen signature forms as needed.

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We recommend that TO management develop procedures detailing the circumstances when Specimen Signature Forms need to be updated.

Management Action Plan

Due Date: Completed

Responsible Person: A. Cloud, Asst. Treasurer

We have documented policies and procedures in narrative format for when Specimen Signature Forms have been updated, as noted above.

Investment Management Fees

During the fiscal year ended June 30, 2010, approximately \$2.9M was paid to Investment Managers for managing 33 portfolios totaling \$876.6M in MERF assets. Fees incurred through November 20, 2010 for the fiscal year ending June 30, 2011 were approximately \$775k for 35 portfolios totaling \$924.5M in MERF assets. Investment Managers use their portfolio market values as the basis for calculating and invoicing the TO for the fees they charge for services provided. Various tests of fees totaling about \$429,000 for five of the 35 portfolios and reviews of related operations disclosed the portfolio market values reported on four of five Investment Manager fee invoices we tested were less than the portfolio market values reported by BNYM for the same period. This resulted in the City paying less management fees; however, a risk of overpayment still exists.

We recommend that TO management document the steps that are taken to monitor portfolio variances when they receive management fee invoices.

Management Action Plan

Due Date: March 31, 2011

Responsible Person: A. Cloud, Asst. Treasurer

IMU management currently has their portfolio market values reconciled between BNY Mellon and the Investment managers. There will always be some minor variances in the market values for non-U.S. portfolios due to differences on foreign currency exchanges on international funds and for emerging market securities due to liquidity constraints. For domestic equities, variances can occur on domestic small cap securities because they tend to be traded over-the-counter and can have liquidity constraints, as well as fixed income securities which are traded over-the-counter and also can have liquidity constraints. When such variances occur, IMU performs a plus or minus 5% threshold and investigates accordingly if the variance is outside of that amount. These procedures will be documented.

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Pension Investment Accounting

The City's Finance Department, not the Treasurer's Office, is responsible for MERF accounting and financial reporting. Various tests of Pension Investment account balances totaling \$876 million as of June 30, 2010 and reviews of related operations disclosed that policies and procedures for MERF accounting were not documented.

We recommend that the Finance Department management document policies and procedures relating to MERF accounting.

Management Action Plan

Due Date: March 31, 2011

Responsible Person: C. Johnson, Acting Finance Director

Finance will document policies and procedures in narrative format for recording pension investment activity in the MUNIS Financial Management System and the City's CAFR.

Proxy Security Voting

TO uses Proxy Voting Services, a division of Institutional Shareholder Services (ISS), to administer its proxy voting obligations. TO management informed us that they were obtaining and reviewing reports or information concerning ISS's progress and activities relating to the Scope of Services in the agreement. While the City Treasurer indicated that the Principal Administrative Assistant views proxy voting either online or via BNYM reports that are generated daily, however, it was not always evident from existing documentation that this was taking place on a regular basis. IMU staff stated that the efforts of the MERF to ensure that proxies reflect all votes that the MERF is eligible for exceed those of the largest and most sophisticated pension funds and endowments. TO staff subsequently provided evidence of successful efforts to ensure that ISS and BNY Mellon reconcile with one another to ensure that the MERF receives ballots that reflect all votes to which it is entitled.

We recommend that TO management document their review of the ISS and BNY Mellon reconciliation of proxy votes for accuracy and completeness.

Management Action Plan

Due Date: March 31, 2011

Responsible Person: A. Cloud, Asst. Treasurer

We will document future reviews of the ISS and BNY Mellon proxy vote reconciliations as noted above.

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